

**Internal Revenue Service**  
Appeals Office  
300 N. Los Angeles St.  
Los Angeles, CA 90012

Release Number: **201429028**  
Release Date: 7/18/2014  
Date: April 25, 2014

**Department of the Treasury**

**Employer Identification Number:**

**Person to Contact:**

**Employee ID Number:**

**Tel:**

**eFax:**

**Tax Period(s) Ended:**

**UIL: 0501 .07-00**

**Certified Mail**

Dear

This is a final determination that you do not qualify for exemption from Federal income tax under Internal Revenue Code (the "Code") section 501(a) as an organization described in Code section 501(c)(7).

The revocation of your exempt status was made for the following reason(s):

Your club facilities are available to the general public on a recurring basis and you received income from this activity that exceeds allowable limits.

You are required to file Federal income tax returns on Forms 1120 for the tax periods stated in the heading of this letter and for all tax years thereafter. File your return with the appropriate Internal Revenue Service Center per the instructions of the return. For further instructions, forms, and information please visit [www.irs.gov](http://www.irs.gov).

Please show your employer identification number on all returns you file and in all correspondence with Internal Revenue Service.

We will make this letter and the proposed adverse determination letter available for public inspection under Code section 6110 after deleting certain identifying information. We have provided to you, in a separate mailing, Notice 437, *Notice of Intention to Disclose*. Please review the Notice 437 and the documents attached that show our proposed deletions. If you disagree with our proposed deletions, follow the instructions in Notice 437.

You also have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States Court. The Taxpayer Advocate can however, see that a tax matters that may not have been resolved through normal channels get prompt and proper handling. If you

want Taxpayer Advocate assistance, please contact the Taxpayer Advocate for the IRS office that issued this letter. You may call toll-free, 1-877-777-4778, for the Taxpayer Advocate or visit [www.irs.gov/advocate](http://www.irs.gov/advocate) for more information.

If you have any questions about this letter, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely Yours,

John Wong  
Acting Appeals Team Manager

Enclosure: Publication 892 and/or 556

**Internal Revenue Service**  
Tax Exempt and Government Entities Division  
TE/GE EO Examinations  
10 Causeway Street Room 581  
Boston, MA 02222

**Department of the Treasury**

501.07-00

Date: May 9, 2011

**ORG  
ADDRESS**

Taxpayer Identification Number:

Form:

Tax Year(s) Ended:

Person to Contact/ID Number:

Contact Numbers:

Telephone:

Fax:

**Certified Mail – Return Receipt Requested**

Dear

We have enclosed a copy of our report of examination explaining why we believe revocation of your organization's exempt status is necessary.

If you accept our findings, please sign and return the enclosed Form 6018-A, *Consent to Proposed Adverse Action*. We will then send you a final letter modifying or revoking your exempt status.

If we do not hear from you within 30 days from the date of this letter, we will process your case on the basis of the recommendations shown in the report of examination and this letter will become final. In that event, you will be required to file Federal income tax returns for the tax period(s) shown above. File these returns with the Ogden Service Center within 60 days from the date of this letter, unless a request for an extension of time is granted. File returns for later tax years with the appropriate service center indicated in the instructions for those returns.

If you do not agree with our position you may appeal your case. The enclosed Publication 3498, *The Examination Process*, explains how to appeal an Internal Revenue Service (IRS) decision. Publication 3498 also includes information on your rights as a taxpayer and the IRS collection process. Please note that Fast Tract Mediation Services referred to in Publication 3498, generally do not apply after issuance of this letter.

If you request a conference, we will forward your written statement of protest to the Appeals Office and they will contact you. For your convenience, an envelope is enclosed.

If you and Appeals do not agree on some or all of the issues after your Appeals conference, or if you do not request an Appeals conference, you may file suit in United States Tax Court, the

United States Court of Federal Claims, or United States District Court, after satisfying procedural and jurisdictional requirements as described in Publication 3498.

You may also request that we refer this matter for technical advice as explained in Publication 892, *Exempt Organization Appeal Procedures for Unagreed Issues*. If a determination letter is issued to you based on technical advice, no further administrative appeal is available to you within the IRS on the issue that was the subject of the technical advice.

You have the right to contact the office of the Taxpayer Advocate. Taxpayer Advocate assistance is not a substitute for established IRS procedures, such as the formal appeals process. The Taxpayer Advocate cannot reverse a legally correct tax determination, or extend the time fixed by law that you have to file a petition in a United States court. The Taxpayer Advocate can, however, see that a tax matter that may not have been resolved through normal channels gets prompt and proper handling. You may call toll-free 1-877-777-4778 and ask for Taxpayer Advocate Assistance. If you prefer, you may contact your local Taxpayer Advocate at:

If you have any questions, please call the contact person at the telephone number shown in the heading of this letter. If you write, please provide a telephone number and the most convenient time to call if we need to contact you.

Thank you for your cooperation.

Sincerely,

Nanette M. Downing  
Director, EO Examinations

Enclosures:  
Publication 892  
Publication 3498  
Form 6018 - A  
Report of Examination  
Envelope

Form <b>886-A</b>	Department of the Treasury - Internal Revenue Service <b>Explanation of Items</b>	Schedule No. or Exhibit
<b>Name of Taxpayer</b> ORG                      EIN: EIN		<b>Year/Period Ended</b> December 31, 20XX and 20XX

**LEGEND**

ORG - Organization name      EIN - ein      XX - date

**ISSUE:**

Whether the ORG will continue to qualify as an exempt social club under section 501(c)(7) of the Code?

**FACTS:**

The ORG (the "ORG") was granted exemption as a social club exempt from Federal income tax under Internal Revenue Code section 501(c)(7) pursuant to a ruling issued on May 7, 19XX. Its purpose as stated in its Articles of Incorporation is: "to help the needy by providing necessities and finding employment and if desirable to maintain a home for old or homeless persons, to care for sick and unfortunate and for the doing of all things incidental and necessary to the purpose of charity."

Currently, ORG's principal activity is providing facilities and services for the pleasure and recreation of its members and their guests. They operate a banquet hall and bar and maintain another house and a large parking lot on the grounds. ORG allows nonmembers to rent the hall for functions and ORG will provide bar service and catering for the event.

During the examination, it was determined that ORG did not comply with the record-keeping requirements of Revenue Procedure 71-17, 1971-1 C.B. 683. However, the examiner used the manager's daily ledger/cash receipts journal to determine the income received from outside its membership. Based on examination of ORG's Form 990-EZ returns for the periods ending December 31, 20XX and 20XX and review of their books and records, the percent of gross receipts from nonmember use of facilities exceeded % for both years of the exam, while investment income was less than % for one year. The percentage of gross receipts from non-member and investment income is noted in the following chart:

Year/Period Ended	% of gross receipts from nonmember use	% of gross receipts from investment income	Total % investment income & nonmember income
December 31, 20XX	%	%	%
December 31, 20XX	%	%	%

The increasing trend of non-member income could be seen in both years 20XX and 20XX. In 20XX and 20XX, the organization received % and % respectively of their income from non-members. This indicates that the organization is using income from non-members to support the activities of its members. There was also evidence that the organization advertises ORG's banquet facilities on the internet. The organization has a web-site, whereby they advertise that they have banquet facilities for all special events; amenities available include catering, bar services, accommodations for up to 300, dance floor, lighting, etc.

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**LAW:**

Organizations exempt from federal taxes as described in IRC Section 501(c)(7) include clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes, and no part of the net earnings of which inures to the benefit of any private shareholder.

Section 1.501(c)(7)-1 of the Income Tax Regulations, relating to the requirements of exemption of such clubs under section 501(a), reads in part as follows:

- (a) The exemption provided by section 501(a) for organizations described in section 501(c)(7) applies only to clubs which are organized and operated exclusively for pleasure, recreation, and other non-profitable purposes, but does not apply to any club if its net earnings inure to the benefit of any private shareholder. In general, this exemption extends to social and recreation clubs which are supported solely by membership fees, dues, and assessments. However, a club otherwise entitled to exemption will not be disqualified because it raises revenue from members through the use of club facilities or in connection with club activities.
- (b) A club which engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber or other products, is not organized and operated exclusively for pleasure, recreation, and other non-profitable purposes and is not exempt under section 501(a). Solicitation by advertisement or otherwise for public patronage of its facilities is prima facie evidence that the club is engaging in business and is not being operated exclusively for pleasure, recreation, or social purposes. However, an incidental sale of property will not deprive a club of its exemption.

Prior to its amendment in 1976, IRC Section 501(c)(7) required that social clubs be operated exclusively for pleasure, recreation, and other non-profitable purposes. Public Law 94-568 amended the "exclusive" provision to read "substantially" in order to allow a section 501(c)(7) organization to receive up to 35 percent of its gross receipts, including investment income, from sources outside its membership without losing its tax exempt status. The Committee Reports for Public Law 94-568 further state:

- (a) Within this 35 percent amount, not more than 15 percent of the gross receipts should be derived from the use of a social club's facilities or services by the general public. This means that an exempt social club may receive up to 35 percent of its gross receipts from a combination of investment income and receipts from non-members, so long as the latter do not represent more than 15 percent of total receipts. These percentages supersede those provided in Revenue Ruling 71-17, 1971-1 C.B. 683.

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- (b) Thus, a social club may receive investment income up to the full 35 percent of its gross receipts if no income is received from non-members' use of club facilities.
- (c) In addition, the Committee Reports state that where a club receives unusual amounts of income, such as from the sale of its clubhouse or similar facilities, that income is not to be included in the 35 percent formula.
- (d) The Senate report also indicates that even though gross receipts from the general public exceed this standard, it does not necessarily establish that there is a nonexempt purpose. A conclusion that there is a nonexempt purpose will be based on all the facts and circumstances including, but not limited to, the gross receipts factor.

Revenue Ruling 58-589 sets forth the criteria for exemption under section 501(c)(7) of the Code, and provides that a club must have an established membership of individuals, personal contacts, and fellowship. It also provides that, while the regulations indicate that a club may lose its exemption if it makes its facilities available to the general public, this does not mean that any dealings with nonmembers will automatically cause a club to lose its exemption. A club may receive some income from the general public, that is, persons other than members and their bona fide guests, or permit the general public to participate in its affairs, provided that such participation is incidental to and in furtherance of the club's exempt purposes, such dealings with the general public and the receipt of income therefrom does not indicate the existence of a club purpose to make a profit, and the income does not inure to club members.

Revenue Ruling 60-324 provides that a social club that made its social facilities available to the general public through its member-sponsorship arrangement can not be treated as being operated exclusively for pleasure, recreation, or other nonprofitable purposes and the club no longer qualified for exemption under 501(c)(7) of the Code.

Revenue Ruling 66-149 provides that a social club is not exempt from federal income tax as an organization described in section 501(c)(7) of the code if it regularly derives a substantial part of its income from non-member sources such as, for example, dividends and interest on investments.

Revenue Ruling 68-119 provides that a club will not necessarily lose its exemption if it derives income from transactions with other than bona fide members and their guests, or if the general public on occasion is permitted to participate in its affairs, provided such participation is incidental to and in furtherance of its general club purposes and the income therefrom does not inure to members.

Revenue Procedure 71-17, 1971-1 C.B. 683 sets forth guidelines for determining the effect of gross receipts derived from use of a social club's facilities by the general public have on the club's exemption under section 501(c)(7) of the Code and recordkeeping requirements. The term "general public" as used in this procedure means persons other than members of a club, their dependents, or guests. Failure to maintain such records or make them available to the Service for examination will preclude use of the minimum gross receipts standard and audit assumptions set forth in this Revenue Procedure.

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Section 6001 of the Code states "Every person liable for any tax imposed by this title, or for the collection thereof, shall keep such records, render such statements, make such returns, and comply with such rules and regulations as the Secretary may from time to time prescribe. Whenever in the judgment of the Secretary it is necessary, he may require any person, by notice served upon such person or by regulations, to make such returns, render such statements, or keep such records, as the Secretary deems sufficient to show whether or not such person is liable for tax under this title."

### **TAXPAYER'S POSITION:**

ORG does not agree to the proposed revocation of their tax exempt status as described in IRC section 501(c)(7).

### **GOVERNMENT'S POSITION:**

IRC§501(c)(7) exempts from taxation clubs organized for pleasure, recreation, and other nonprofit purposes, substantially all of the activities of which are for such purposes and no part of the net earning of which inures to the benefit of a private shareholder. The ORG allows regular non-member use of their facilities. The income derived from non-members is used, as with other income, to operate and maintain the facility. This non-member income therefore inures to the benefit of the members which is prohibited under IRC§501(c)(7).

Treas. Reg. 1.501(c)(7)-1(b) states: A club which engages in business, such as making its social and recreational facilities available to the general public or by selling real estate, timber, or other products, is not organized and operated exclusively for pleasure, recreation, and other nonprofit purposes, and is not exempt under section 501(a). ORG regularly allows non-members use of the facilities. Along with the long-term lease of the first floor, non-members may rent the dining area, and purchase liquor and/or food from the kitchen and function bar.

An organization exempt from federal income taxes as described in IRC section 501(c)(7) must meet the gross receipts test in order to maintain its exemption. In order to meet the gross receipts test, an organization can receive up to \_\_\_\_\_ (%) of its gross receipts, including investment income, from sources outside its membership without losing its tax exempt status. Within this % amount, not more than fifteen percent (15%) of the gross receipts should be derived from the use of a social club's facilities or services by non-members. Public Law 94-568, and the related Senate Report No. 94-1318, 2d Session, 1976-2 C.B. 597, states that the exemption of a social club exempt under 501(c)(7) of the Code is jeopardized if they receive over \_\_\_\_\_ percent of their gross income from non-member use of facilities or services. The ORG has exceeded the \_\_\_\_\_ % gross receipts standard for nonmember income on a continuous basis for at least two years. The nonmember receipts are earned throughout the year. There was no one single or unusual event that caused the club to exceed the \_\_\_\_\_ % threshold.

Based on the large percentages of nonmember income to total gross receipts of the club, (i.e., \_\_\_\_\_ % and \_\_\_\_\_ % as noted in the above table), which exceeds the limitation of 15% as set forth by IRC 501(c)(7) for each of these years and the fact that it advertises the use of its

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facilities to the public, it is the Government's position that the Club is no longer operated exclusively for the pleasure and recreation of it's members and is not exempt under section 501(c)(7).

**CONCLUSION:**

ORG was offered a closing conference by the revenue agent to discuss the proposed revocation but the offer was declined. The IRC Section 501(c)(7) tax exempt status of the ORG should be revoked since the nonmember income received by ORG exceeded 15% of ORG's total gross receipts for the years under examination. The organization has established a pattern of receiving less than half of its gross income from its membership. Further, it advertises the use of their facilities to the general public reflecting evidence that ORG is engaged in a business and is not being "operated exclusively for pleasure, recreation, or social purposes."

The ORG no longer meets the requirements to qualify as exempt from federal income tax under IRC section 501(a) as described in section 501(c)(7). Therefore, your exempt status under 501(c)(7) of the Internal Revenue Code will be revoked effective January 1, 20XX. As a taxable entity, the organization is required to file Form 1120, U.S. Corporation Income Tax Return for the periods open under statute, whether or not you have taxable income. Under 6501(g) these periods include the years ending December 31, 20XX and subsequent tax years. Additionally, the organization is reminded of the provisions of IRC 277 concerning membership organizations which are not exempt organizations.

**ALTERNATIVE ISSUE:**

Should the income from investments and non-members be taxable as unrelated business income under section 511 of the Code?

**BRIEF EXPLANATION OF FACTS:**

The organization received more than % of their gross receipts, including investment income, from sources outside their membership. They rented the club facility and provided services to non-members for private events and functions. The amount of gross receipts from non-member and investment income is noted in the following chart:

Year/Period Ended	Gross receipts from nonmember use	Gross receipts from investment income	Total investment income & nonmember income
December 31, 20XX	\$	\$	\$
December 31, 20XX	\$	\$	\$

**LAW:**

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Section 511(a) of the Code imposes a tax upon the unrelated business taxable income of organizations exempt from federal income tax.

Section 512(a) defines unrelated business taxable income as the gross income from any unrelated trade or business regularly carried on by the organization.

Section 513(a)(3) of the Internal Revenue code states the term "unrelated business taxable income" means gross income (excluding any exempt function income), less the deductions allowed which are directly connected with the production of the gross income (excluding exempt function income), both computed with the modification provided in paragraphs (c), (10), (11), and (12) of subsection (b). One of the organizations subject to the provisions of the Internal Revenue Code subsection 512(a)(3) are membership organizations whose principal purpose is to provide social and recreational activities to its members. The reason for the special rule of the Internal Revenue Code subsection 512(a)(3) was to prevent membership organizations from providing increased benefits to their members from untaxed sources of non-membership income.

#### **TAXPAYER'S POSITION:**

ORG does agree that it should file Form 990-T, Exempt Organization Business Income Tax Return, and pay federal income tax on its unrelated business income received from non-member sources.

#### **GOVERNMENT'S POSITION:**

If revocation is not upheld, then the organization should pay federal income tax on its unrelated business income received from non-member sources.

#### **CONCLUSION:**

If revocation is not upheld, then the organization should pay federal income tax on its unrelated business income received from non-member sources. Income received from non-members for use of the facility and all investment income, including rental income, should be reported and the tax calculated on Form 990-T, Exempt Organization Business Income Tax Return.